COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, DECEMBER 18, 2001

APPLICATION OF

MECKLENBURG ELECTRIC COOPERATIVE CASE NO. PUE010004

For approval of a functional
separation plan

FINAL ORDER

On December 29, 2000, Mecklenburg Electric Cooperative ("Mecklenburg" or the "Cooperative"), filed an application for State Corporation Commission ("Commission") approval of the Cooperative's plan for functional separation ("Plan") as required by the Virginia Electric Utility Restructuring Act ("the Act"), Chapter 23 of Title 56 of the Code of Virginia (§ 56-576 et seq.). The Act requires that the Commission complete its review of proposed plans of separation by January 1, 2002, and that transition to competition be implemented according to a timeline established by the Commission. Pursuant to an Order issued on March 30, 2001, in Case No. PUE000740, the Commission established January 1, 2004, as the deadline for Mecklenburg and other electric cooperatives to provide full retail access for their customers.

The Commission promulgated rules[1] for functional separation as required by the Act. These Rules require the Cooperative to file a Plan that includes a cost of service study separating the Virginia jurisdictional operations into functions: generation, transmission, and distribution, subdivided by class and specifically identifying the costs associated with metering and billing. The Rules also require that the Plan include proposed unbundled rates, tariffs, and terms and conditions for service. Requests for waiver from the required submission of documents under the various sections of the Rules are also permitted.

In its application, the Cooperative stated that it is currently functionally separated. It does not own or control any generation or transmission facilities, nor does it own or control any affiliated entity that owns or controls generation or transmission facilities. Instead, Mecklenburg purchases all of its requirements for demand, energy, transmission and ancillary services through contracts with Old Dominion Electric Cooperative and Southeastern Power Administration. As such, Mecklenburg stated that it had no plans to divest itself of any generation assets, to create any new functionally separate entity, or to propose to transfer any functions, services, or employees to a functionally separate entity or third party. The Cooperative filed a cost of service study which included

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[1] Commission's Regulations Governing the Functional Separation of Incumbent Electric Utilities under the Virginia Electric Utility Restructuring Act ("Rules"), 20 VAC 5-202-10 et seq., adopted in Case No. PUA000029.

proposed unbundled rates to illustrate the Cooperative's rate unbundling. In its application, the Cooperative requested a waiver of the requirement of 20 VAC 5-202-40 B 7 a of the Rules that its cost of service be based on a test year beginning no earlier than January 1, 1999.[2] The Cooperative also requested that the Commission waive the requirement of 20 VAC 5-202-40 B 8 of the Rules to file unbundled tariff rates and terms and conditions of service with the Cooperative's functional separation plan and that such waiver extend until the conclusion of this proceeding so it can finalize and submit such filings in compliance with the final order.

In an Order dated April 4, 2001, in this proceeding, the Commission directed the Cooperative to provide notice to the public and established a procedural schedule for the filing of comments or requests for hearing on Mecklenburg's application. In that Order, the Commission directed its Staff to investigate the application and file a Report detailing its findings and recommendations on or before July 20, 2001. The Commission also granted Mecklenburg's request for a waiver. However, the Commission required the Cooperative to file tariff terms and conditions of service in time for the Commission to consider them and to require notice, if necessary and appropriate, prior

[2] Staff did not oppose use of the Cooperative's proposed test year of calendar year 1998.

to the Cooperative's implementation of retail choice to its customers.

On June 4, 2001, AES NewEnergy, Inc. ("AES") filed a Notice of Protest and request for hearing in this matter. Specifically, AES requested that a hearing schedule be established to consider issues relating to the allocation of certain costs to the generation and transmission ("G&T") functions, a dual billing option for suppliers, wires charge calculations, and the terms and conditions of service included in any rate tariff or supplier coordination agreement.

On July 20, 2001, Staff filed its Report wherein it recommended that the Commission approve Mecklenburg's Plan with the adoption of certain modifications recommended by Staff. Specifically, Staff recommended that the Commission adopt the following: Staff's recommendation to consolidate the Cooperative's G&T functions into one function;[3] Staff's adjustments to the Cooperative's per books cost of service study; Staff's allocations of expense and rate base to the G&T function; Staff's recommendation that the Commission direct the Cooperative to track the costs associated with G&T operations; and Staff's recommendation that the Commission direct Mecklenburg to provide tariff rates and terms and conditions of service in time for full consideration by the Commission.

[3] Staff noted that the Cooperative does not anticipate providing transmission service to customers who shop for energy.

On August 1, 2001, AES withdrew its request for hearing in this case, stating that it lacked sufficient resources to participate in hearings in every electric cooperative case in the Commonwealth of Virginia, and instead would focus its resources in Case No. PUE010007, Rappahannock Electric Cooperative's application for approval of a functional separation plan.

On August 3, 2001, AES submitted comments on Mecklenburg's application. In its comments, AES stated that it supports all of Staff's recommendations. In particular, it agrees with Staff's assertion that the components of the Cooperative's unbundled rates identified as G&T are derived solely from the bundled wholesale power rates paid to the Cooperative's generation suppliers, the Old Dominion Electric Cooperative and the Southeastern Power Administration and supports the additional cost allocation proposed by Staff. Further, AES recommended an allocation of operational costs for billing and collection and customer support costs based on Staff's proposed unbundled operating expense factor.

Also on August 3, 2001, Mecklenburg filed its Response to Staff's Report. In its Response, the Cooperative stated that although it supports Staff's recommendation that the G&T functions be combined, it does not agree with Staff's recommendations pertaining to functional cost assignment. Mecklenburg requests that the Commission find that its administrative and general ("A&G") expenses and associated overheads are properly assignable to the distribution function because the rate paid by Mecklenburg to Old Dominion Electric Cooperative for power supply and transmission services includes a component for A&G expenses. Mecklenburg argued that assigning its A&G and overheads to G&T would, in effect, add a second layer of such costs to the generation component. Further, Mecklenburg argues that in its role as the local distribution service provider, it is required by the Act to provide default generation service under its capped rates. According to Mecklenburg, supplying default generation services provides a benefit available for all consumers on Mecklenburg's distribution system, including those consumers who may choose an alternative power supplier. Mecklenburg further stated that the responsibility bestowed on it to provide default service is a function of its role as the distribution utility. Thus, the Cooperative urges the Commission to reject Staff's proposal to assign A&G costs to the G&T functions.

With regard to Staff's recommendations concerning uncollectible expense, customer deposits, and interest on customer deposits, Mecklenburg agreed that a portion of these expenses should be attributed to G&T, but took issue with the Staff's method of allocation. Specifically, the Cooperative disagreed with Staff's methodology of using a three-year net charge off rate to normalize the level of uncollectible expense in its cost of service. Mecklenburg argues that Staff's uncollectibles expense methodology is inappropriate because an abnormal write off of an industrial customer occurred in 1997. The Cooperative proposes using the test year's net charge off ratio to derive a normalized expense. Mecklenburg also disagreed with Staff's proposals regarding assignment of costs relating to conservation advertising and load management to the G&T function. Further, the Cooperative also requested that the Commission not require it to track costs purportedly associated with G&T operations as proposed by Staff.

On September 20, 2001, Staff filed a motion for leave to file a Reply to Mecklenburg's Response, and its Reply. The Commission granted this motion on October 30, 2001, and permitted the Cooperative to respond to Staff's Reply by November 16, 2001. In its Reply, Staff maintained its position that A&G costs should be allocated to G&T and that if these costs are shifted to Distribution, rates established for Distribution will subsidize those of G&T, contrary to § 56-590 D of the Code of Virginia, which requires the Commission to set rates that will not result in cost shifting or cross-subsidies between functional units. Staff also believes that it is appropriate to allocate payroll and related overheads based on an A&G labor factor, and has used a total labor factor to allocate other A&G costs.

Staff also reiterated its proposal to functionalize a portion of uncollectible expense, customer deposits and interest on customer deposits, conservation advertising costs and all costs associated with Mecklenburg's load management programs to G&T. In addition, Staff disagreed with Mecklenburg on (i) the proper ratio to use to allocate a portion of uncollectible expense, customer deposits, and interest on customer deposits to G&T, and (ii) the class or classes to which load management costs should be allocated.

Mecklenburg filed its response to the Staff's Reply on November 16, 2001. In its response, Mecklenburg maintained that failure to attribute additional A&G expenses to the generation function does not result in cost-shifting or cross-subsidization of functionally separate units. In addition, Mecklenburg urged the Commission to consider its unique statutory obligation to provide default services in Virginia. The Cooperative continued to agree with Staff that a portion of uncollectible expense, customer deposits, and interest on customer deposits should be assigned to the G&T function, but stated that the ratio used should be based on G&T revenues as a percentage of total revenues. With regard to conservation advertising and load management costs, the Cooperative maintained its position that all conservation advertising and 50% of load management costs should be considered part of the distribution function.

NOW THE COMMISSION, having considered the Cooperative's application, Staff's Report, the subsequent pleadings, and applicable law, is of the opinion and finds that the application should be approved, subject to the modifications detailed herein. We will also grant Mecklenburg's request for a waiver of 20 VAC 5-202-40 B 7 a of the Rules.

With respect to the issue of the proper allocation of A&G costs supporting the procurement of wholesale power, we find that the Commission has an obligation pursuant to § 56-590 D of the Code of Virginia to see that no cross-subsidies occur. The function causing the cost should be allocated such costs. A&G costs associated with the procurement of wholesale power support the G&T function, and as such, should not be allocated to the Distribution function. We will, therefore, accept Staff's adjustment allocating certain A&G costs associated with obtaining wholesale power to the Cooperative's G&T function. Further, we accept Staff's functional allocation of payroll and related overheads based on the A&G labor factor.

There are two ways that a cooperative may recover A&G costs associated with the procurement of wholesale power. If a customer remains with the cooperative, the cooperative will recover such costs from the customer. If the customer leaves the cooperative, and the embedded cost of generation exceeds the market, the cooperative will have the opportunity to recover the cost through the wires charge.

We likewise agree with Staff that the allocation factor for uncollectible expense, customer deposits, and interest on customer deposits should be based on each function's relative level of operating expense. We believe this is a reasonable approach in this situation as total G&T expense must be calculated in order to determine the level of G&T revenues, and operating expenses can be used to simulate unbundled revenue.

With regard to the costs for conservation advertising and load management, we find that these costs should be fully allocated to G&T, and that load management and related costs should be allocated across all customer classes, not just the residential class. Both the conservation advertising and load management costs are clearly related to generation, not distribution. The goal of conservation advertising is to reduce energy usage, thereby having a direct impact on generation and purchased power costs. Load management switches installed for peak shaving are a G&T component because they allow the Cooperative to decrease its power costs by negotiating better rates from the supplier, and the Cooperative would not have load management switches simply for distribution purposes. Further, we agree with Staff that since all customers share in the benefits of lower wholesale power bills, all customers should share the costs, not just the residential class.

With respect to the level of uncollectibles expense in cost of service incurred by Mecklenburg, we agree with the

Cooperative’s position that using the test year’s net charge off ratio to derive a normalized expense is the appropriate methodology for normalizing the level of uncollectibles expense in the cost of service.

AES proposed in its comments an allocation of billing and collection and customer service costs to G&T. We find that the allocation of billing and collection should be limited to the incremental costs of providing billing information to and coordinating with competitive service providers. We find that customer accounts should be allocated based on the activity that gives rise to the costs, rather than the general unbundled operating expense factor. While information for determining the preferred functional allocation of these costs is not available, the use of the unbundled operating expense factor as a proxy would overstate the portion of these costs supporting G&T. We therefore find that there should be no allocation of billing and collection and customer service costs at this time.

We find that G&T costs, as defined in this Order, should be tracked prospectively by the Cooperative in order to ensure accurate functional allocations in any future proceedings before the Commission. We also direct the Cooperative to begin tracking the incremental costs associated with billing and collection costs, as well as the activities that give rise to the customer service and legal and regulatory costs.

Finally, in its cost of service study, Mecklenburg discusses the impact of its monthly fuel adjustment factor in relation to the determination of the market price for generation and the wires charge. It is the Cooperative's position that fuel adjustments can be applied monthly without violating §§ 56-582 and 56-583 of the Code of Virginia. We are not persuaded by the Cooperative's argument on this point. However, because it is not necessary that we resolve this issue prior to January 1, 2002, we will defer our consideration of it until next year. In the interim, we direct Staff to (i) consult with Mecklenburg, the other electric cooperatives, and any other interested parties on this issue and (ii) submit a written recommendation to the Commission on or before March 1, 2002, on whether we should implement an annual fuel factor adjustment for the cooperatives in lieu of the current fluctuating monthly fuel charge.

Accordingly, IT IS ORDERED THAT:

(1) Mecklenburg's Plan for functional separation pursuant to the Virginia Electric Utility Restructuring Act is hereby approved, subject to the modifications discussed herein.

(2) Mecklenburg's request for waiver of 20 VAC 5-202-40 B 7 a requiring that its cost of service be based on a test year beginning no earlier than January 1, 1999, is granted.

(3) On or before March 1, 2002, the Staff shall submit a written recommendation to the Commission on whether we should

transition to an annual fuel factor adjustment for the cooperatives from the current fluctuating monthly fuel charge, and if so, how such a transition should occur.

(4) Mecklenburg shall provide tariffs and terms and conditions of service to the Division of Energy Regulation that conform to this Order and all applicable Commission Rules and Regulations one hundred fifty (150) days prior to its implementation of retail choice.

(5) This case is hereby dismissed, and the papers shall be placed in the file for ended causes.